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Our business was also affected by other developments that had significant impacts late in the year. They included the business combination between historical Alcatel and Lucent, which was completed in November 2006 and the announcement of our pending acquisition of Nortel Networks Corporation's UMTS business in December 2006, which created uncertainty for our customers, and shifts in spending by large customers due to carrier consolidation.

As a result of the generally improved market environment, our revenues increased by 9.5% in 2006 as compared to 2005. Of the 9.5% increase, a significant portion is attributable to the inclusion of Lucent's results in December 2006. The impact of currency exchange rate changes on revenue growth was marginal in 2006. For 2006, our gross margin was 33.1%, a decrease from 36.8% in 2005 that was primarily due to competitive pricing pressures in our carrier market. Income from operating activities before restructuring costs, impairment of intangible assets and gain on disposal of consolidated entities was 5.7% of revenues for 2006 compared to 9.1% in 2005. The decrease resulted from the competitive pricing environment that impacted our gross profit and from the impact of purchase accounting entries resulting from the Lucent business combination.

We expect to make total pre-tax cost savings of €1.7 billion by 2009, with at least €600 million of such savings to occur in 2007. These savings take into account such factors as the optimization of the supply chain and services, optimization of resources and product rationalization. These actions should improve our competitiveness in our industry, but are expected to impact approximately 12,500 jobs over the next three years. We believe that the uncertainties of the fourth quarter of 2006 linked to the merger, and a highly competitive market environment will diminish over time, but will continue to have an impact on our operations in the early months of 2007. We expect some decline in revenues for the first quarter of 2007, but we believe that we can return to growth during the remainder of 2007. Looking forward to the full year 2007, we expect revenues to increase on a percentage basis in an amount at least equal to the carrier market growth rate of mid-single digits..

Recent Events

Announcement of 2006 dividend. Our board of directors has announced that it will propose at the annual shareholders' meeting to be held on June 1, 2007 to pay a dividend of €0.16 per ordinary share and ADS for 2006.

Update on Thales transaction. At the extraordinary general shareholders' meeting held on January 5, 2007, Thales shareholders approved the resolutions relative to the contribution of our transportation and security activities to Thales. On January 5, 2007, the two activities were transferred to Thales and we received 25 million new Thales shares and a cash payment of €50 million, including purchase price adjustments. The sale of our space activities to Thales for cash should be finalized during the first half of 2007.

Highlights of Transactions during 2006

Acquisitions

Acquisition of UMTS business from Nortel. On December 4, 2006, we signed an agreement with Nortel Networks Corporation (or Nortel) to acquire Nortel's UMTS (Universal Mobile Telecommunications System) radio access business (including the technology and product portfolio), associated patents and tangible assets, as well as customer contracts and other related assets, for $320 million. The acquisition was completed on December 31, 2006.

Merger with Lucent. On November 30, 2006, pursuant to an Agreement and Plan of Merger (the "Merger Agreement"), dated April 2, 2006, between us, Lucent Technologies Inc., a Delaware corporation ("Lucent"), and Aura Merger Sub, Inc. ("Merger Sub"), our wholly-owned subsidiary, Merger Sub merged with and into Lucent, with Lucent surviving the merger and continuing its existence as our wholly-owned subsidiary. At the effective time of the merger, the combined company was renamed "Alcatel Lucent."

As a result of the merger, each share of Lucent common stock issued and outstanding immediately prior to the effective time of the merger was converted into the right to receive 0.1952 (the "Exchange Ratio") of an ADS representing one ordinary share, nominal value €2.00 per share, of Alcatel-Lucent. Outstanding options to purchase shares of Lucent common stock granted under Lucent's option plans were converted into the right to acquire our ordinary shares, with the exercise price and the number of ordinary shares adjusted to reflect the Exchange Ratio. Lucent's warrants and convertible debt securities outstanding at the effective time of the merger also became exercisable for or convertible into our ADSs and ordinary shares adjusted to reflect the Exchange Ratio.

Acquisition of VoiceGenie. During the second quarter of 2006, we acquired privately-held VoiceGenie for €30 million in cash. Founded in 2000, VoiceGenie is a leader in voice self-service solutions, with a software platform based on Voice XML, an open standard used for developing self-service applications by both enterprises and carriers. The contribution of this company to our 2006 financial results was not significant.

Acquisition of 2Wire. On January 27, 2006, we acquired a 27.5% stake in 2Wire, a pioneer in home broadband network solutions, for a purchase price of $122 million in cash. This company is consolidated under the equity method and its contribution to our 2006 financial results was not significant. Goodwill accounted for in share of net assets of equity affiliates as of December 31, 2006 was €37 million.

Dispositions

Thales. On December 1, 2006, we signed an agreement with Thales for the transfer of our transportation, security and space assets to Thales and on the future industrial cooperation of the two groups. This agreement follows the execution in 2006 of an agreement among us, Thales and Finmeccanica S.p.A., an Italian aerospace and defense company, in which Finmeccanica agreed to the transfer to Thales of our 67% interest in Alcatel Alenia Space and our 33% interest in Telespazio Holding, our two joint ventures with Finmeccanica.

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With respect tho the transfer of the space activities, we will receive €670 million in cash, subject to adjustment. The French State will remain Thales' main shareholder with a 26.74% stake (compared with 31.26% previously). On December 28, 2006, we entered into a new Shareholders' Agreement with TSA, a French company wholly owned by the French State, with a four–year term that is renewable for five–year periods, replacing the existing shareholders' agreement between historical Alcatel, Groupe Industriel Marcel Dassault S.A. and the French State.

As discussed in "Recent Events" above, we completed the transfer to Thales of our transportation and security activities on January 5, 2007 and received 25 million new Thales shares and €50 million in cash. As a result, our interest in Thales increased from 9.46% to 20.95%.

Other Transactions

Buy–out of Fujitsu joint venture. In August 2006, we acquired Fujitsu's share in Evolium 3G, our wireless infrastructure joint venture with Fujitsu.

Change in credit rating. On December 5, 2006, subsequent to the completion of the business combination with Lucent, Standard & Poor's downgraded our ratings to BB– (current as of March 28, 2007) from BB for our long–term debt, citing the challenges that we will face combining two large organizations. On December 11, 2006, Moody's downgraded our ratings to Ba2 (current as of March 28, 2007) from Ba1 for our long–term debt, citing execution challenges relating to the integration of two large companies.

Highlights of Transactions during 2005

Acquisitions

Acquisition of Native Networks. On March 17, 2005, we completed the acquisition of Native Networks, Inc., a provider of optical Ethernet goods and services, for U.S.$55 million in cash.

Dispositions

Sale of shareholding in Nexans. On March 16, 2005, we sold our shareholding in Nexans, representing 15.1% of Nexans' share capital, through a private placement.

Sale of electrical power systems business. On January 26, 2005, we completed the sale of our electrical power business to Ripplewood, a U.S. private equity firm.

Other Transactions

Amendment of credit facility. On March 15, 2005, we amended our existing syndicated revolving €1.3 billion credit facility by extending the maturity date from June 2007 to June 2009 with a possible extension until 2011, eliminating one of the two financial covenants, reducing the cost of the facility and reducing the overall amount to €1.0 billion.

Merger of space activities. On July 1, 2005, we completed the merger of our space activities with those of Finmeccanica, S.p.A., an Italian aerospace and defense company, through the creation of two sister companies. We own approximately 67%, and Alenia Spazio, a unit of Finmeccanica, owns approximately 33%, of the first company, Alcatel Alenia Space, that combines our respective industrial space activities. Finmeccanica owns approximately 67%, and we own approximately 33%, of the second company, Telespazio Holding, which combines our respective satellite operations and service activities.

Exchange of our interest in joint venture with TCL Communication. On July 18, 2005, we exchanged our 45% shareholding in our joint venture with TCL Communication Technology Holdings Limited (see "Highlights of Transactions during 2004 — Other Transactions — Creation of joint venture for mobile handset business" below) for shares of TCL Communication, which resulted in TCL Communication owning all of the joint venture company and our owning 141,375,000 shares of TCL Communication.

Highlights of Transactions during 2004

Acquisitions

Acquisition of Spatial Wireless. On December 16, 2004, we completed the acquisition of Spatial Communications Technologies, Inc. for consideration consisting of our American Depositary Shares, or ADSs, having a value of €223 million (based on the market value of our ADSs on the date of the acquisition). Spatial developed and marketed mobile switching equipment that can operate using any of the major mobile technologies and related software. Through this acquisition we are able to offer next–generation mobile switching equipment and will facilitate our ability to provide carriers with systems that can be updated relatively easily in the future.

Acquisition of eDial. On September 17, 2004, we acquired eDial for consideration consisting of cash and ADSs having an aggregate value of €22 million (based on the market value of our ADSs on the date of the acquisition). eDial provides conferencing and related services for businesses and carriers. This acquisition complemented our communications software development strategy.

Dispositions

Sale of battery business. On January 14, 2004, we completed the sale of our battery business, Saft, to Doughty Hanson, a European private equity firm, for €390 million in cash.

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Other Transactions

Sale of a portion of shareholding in Avanex. On December 14, 2004, we sold a portion of our shareholding in Avanex in a block trade market transaction, which reduced our shareholding in this company to 19.65% of its share capital.

Creation of joint venture for mobile handset business. On August 31, 2004, our joint venture with TCL Communication Technology Holdings Limited commenced operations. This joint venture engaged in research and development, manufacturing, and sales and distribution of mobile handsets and peripheral devices. We contributed cash and our mobile handset business having an approximate aggregate value of €45 million in exchange for a 45% equity stake in the joint venture, and TCL Communications contributed cash of €55 million in exchange for a 55% equity stake in the joint venture.

Creation of joint venture for optical fiber cable business. On July 1, 2004, we combined our global fiber and communication cable business with that of Draka Holding, N.V., a Dutch cable and cable systems producer, and created a new company, Draka Comteq B.V., owned 50.1% by Draka and 49.9% by us.

Business organization

The chart below shows how our principal business activities were organized from January 1 through November 30, 2006, prior to completion of the business combination with Lucent.

Fixed Communications	Mobile Communications	Private Communications
• Access Networks	• Mobile Radio	• Enterprise Solutions
• Fixed Solutions	• Mobile Solutions	• Space Solutions
• Internet Protocol	• Wireless Transmissions	• Transport Solutions
• Optical Networks		• Integration and Services

Following the completion of the transaction with Lucent, we reorganized our business. The chart below sets forth our three current business segments: Carrier, Enterprise and Services.

Carrier			Enterprise	Services
WIRELINE	WIRELESS	CONVERGENCE		
• Access	• GSM/WiMax	• Multicore	• Enterprise Solutions	• Maintenance
• Internet Protocol	• W-CDMA	• Multimedia & Payment	• Genesys	• Professional Services
• Optics	• CDMA/EVDO	• IMS Applications & Services		• Network Integration
	• Wireless Transmission			• Network Operations

The carrier business segment includes the majority of historical Alcatel's former fixed communications and mobile communications business segments and the majority of Lucent's former network solutions group. The Enterprise segment consists largely of historical Alcatel's former enterprise solutions business, which was previously reported within the private communications group. The new Services segment is comprised of Lucent's former worldwide services organization, along with the services activities (deployment, maintenance, integration, etc.) that had been included in historical Alcatel's fixed, mobile and private business segments.

Unless noted otherwise, all the financial data discussed in this item 4 can be found in our consolidated financial statements at December 31, 2006 and includes Lucent's results from December 1, 2006. For financial information by operating segment and geographic market, see Note 4 to our consolidated financial statements and Item 5 — "Operating and Financial Review and Prospects" included elsewhere herein.

Carrier

Our carrier business segment is comprised of the wireline, wireless, and convergence business groups, and it supplies a broad portfolio of products used by fixed, mobile, and converged carriers in all facets of their network operations. A key development currently ongoing within the carrier market – and particularly in the wireline carrier market – is the transformation of networks to a high bandwidth, full Internet Protocol (or IP) architecture providing enhanced triple play services (voice, data and video) to end users. We are focused on supporting this transformation occurring in our industry, as evidenced by our investments in next-generation technologies like IP Multimedia Subsystem (or IMS), third generation mobile networks, next-generation optical networking, and wireline broadband access. In 2006, our carrier business segment revenues were €8,989 million (excluding inter-company sales), representing 73.2% of our total revenues.

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Wireline

General. The wireline business group has three business divisions: access, optics and Internet Protocol (or IP), each of which includes operations and products from both historical Alcatel and Lucent. The portfolio of products supplied by the wireline group is deployed anywhere from core networks to access networks, in legacy and next−generation networks, facilitating the delivery of voice, data and video services. In 2006, our wireline business group revenues were €4,463 million (excluding inter−company sales), representing 49.6% of the carrier segment revenues and 36.3% of our total revenues.

Access. We are the worldwide leader in broadband access, a market that had previously been dominated by copper−based, digital subscriber line (or DSL) technology, but which now also includes optical fiber−based Passive Optical Networking (or PON) technology. We offer access products developed by historical Alcatel and Lucent, and our fiber−based products are complementary to our DSL products, depending on the network configuration and the area of installation. We believe that our large installed DSL base provides us with a competitive advantage as many of our DSL customers build optical fiber deeper into their access networks, closer to the end−user, in order to enhance their offerings with fiber−based services. These products allow carriers to migrate their end−user customers from dial−up service to high−speed Internet connections by providing the capability to transport information at high speeds over high−capacity or "broadband" lines. Those lines may be copper wire or optical fiber, with fiber offering higher transmission speeds and more capacity than copper. These access products enable carriers to generate additional revenues by providing advanced services to their residential and business customers. Our newest family of access products, which is IP−based, is displacing older Asynchronous Transfer Mode (or ATM)−based products. These products are designed to accommodate expanding demand for new applications requiring greater bandwidth. For example, our products permit carriers to offer voice, data and video (triple play functionality), and to deliver to their customers virtually unlimited broadcast channels, video on demand, HDTV (high definition TV), VoIP (voice over IP), high speed Internet, and business access services. The functionality of our products serves the needs of the carriers' urban, suburban and rural customers.

Internet Protocol. Both historical Alcatel and Lucent products comprise our portfolio of data offerings, which are led by three product families – multi−service multi−protocol switches, service routers and Ethernet service switches.

- our multi−service wide−area−network (or MS WAN) switches have been designed to provide flexibility to carriers when they build and expand their networks. They are based on a blend of technologies, which has integrated IP and multi−protocol switching functions, thereby allowing carriers to expand their service offerings at their option and to adapt their networks to meet the growth in Internet traffic;
- a service router is a device that interconnects computer networks and moves information from one network to another;
- our Ethernet service switches enable carriers to deliver virtual private networks (or VPNs), and triple play offerings (data, voice and video) using an Ethernet standard. Ethernet was once found exclusively in enterprise−type local−area networks. More recently, enhanced reliability and quality−of−service capabilities have allowed Ethernet to penetrate carrier networks as well, frequently at the expense of spending for multi−service equipment.

Each of these products is designed to deliver high margin data services, including the full variety of network−based VPNs and other data services used for business applications. Our service routers feature a new generation of processing power and many customized and scaleable applications designed to appeal to carriers. They provide high value, differentiated IP services to businesses. Our newest service router, which is optimized for smaller points of presence, was introduced in early 2006. We believe our service routers provide services and applications that go well beyond what is possible with the single purpose routing products that are generally available today. In the service router market, we have been recognized as the number two vendor worldwide in deploying routers at the edge of carrier networks.

We have developed an IP portfolio of products to meet our customers' varying requirements. For instance, our multi−service switches can interface with our service routers to deliver seamless networking services regardless of technology. Seamless interfacing between the two products allows carriers to combine their newer IP or Ethernet−based networking products with their older network or legacy services to offer customers a smooth service migration to these more advanced technologies.

Optics. Our optics division produces equipment to transport information for long distances over land (terrestrial) and undersea (submarine), as well as for short distances in metropolitan and regional areas. According to industry analyst OVUM/ RHK, historical Alcatel has had the largest optical networking market share since 2001, a position that was augmented by the addition of Lucent's optical networking portfolio.

Terrestrial. Our terrestrial products are designed for long haul and metropolitan/regional applications. With our products, carriers can manage voice, data and video traffic patterns based on different applications or platforms and can benefit from new competitive service offerings by introducing a wide variety of data−managed services, including different service quality capabilities, variable service rates and traffic congestion management. Most importantly, these products allow our customers to offer these new services without impacting their existing investment program for their current networks. Our metro WDM (wave division multiplexing) products address carriers' requirements for cost−effective networks to meet their growing business and data networking needs. Both our metro and long haul WDM products offer the added capacity required to support video services, and they are scaleable, in that they permit our customers to easily enlarge their networks as their business and data networking needs grow. These products provide cost−effective, managed platforms that support different services and are suitable for applications in diversified network configurations.

Submarine. We are an industry leader in the development, manufacture, installation and management of undersea telecommunications cable networks. This market is characterized by a few large contracts that often require more than one year to complete. These massive investments are concentrated on trans−Pacific links, around Africa, across the Mediterranean and in southeast Asia as well as around the Indian sub−continent. Our submarine network systems can connect continents (using regeneration due to the long distances), as well as span distances up to 400 km (using no regeneration) to connect mainland and an island, or several islands together or many points along a coast.

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Wireless

General. Our wireless business group serves the needs of wireless carriers throughout the world as they transform their existing infrastructures to more flexible, competitive, end–to–end IP–based networks that can support existing voice as well as new data and video traffic. We provide an extensive range of mobile communications products across all the major established technology standards, including GSM/GPRS/EDGE, W–CDMA (Wideband Code Division Multiple Access, commonly referred to as W–CDMA and also referred to as Universal Mobile Telephone Communications Systems, or UMTS) and CDMA, as well as nascent technologies like WiMAX. Our mobile radio products are designed to minimize total cost of ownership through a continuous re–engineering program and the use of a highly modular framework that facilitates rapid network deployment and expansion, flexible network evolution, including the easy introduction of new technologies and easier maintenance, and allows for the evolution of second generation networks to third generation (or 3G), without loss of operability. Our GSM/GPRS/EDGE business came from historical Alcatel, our market–leading CDMA business came from Lucent, and our W–CDMA business is a combination of assets and customers from both companies and also includes the UMTS radio business that we acquired from Nortel on December 31, 2006. In 2006, our wireless business group revenues were €3,049 million (excluding inter–company sales), representing 33.9% of our carrier segment revenues and 24.8% of our total revenues.

GSM/WiMAX. We develop Evolium mobile radio products for the second generation (or 2G) GSM (Global System for Global Communications) standard, including the GPRS/EDGE (General Packet Radio Service/ Enhanced Data Rates for GSM Evolution) technology upgrades to that standard. In 2006, the GSM market experienced heightened competition, but remained the world's leading mobile technology in terms of the number of subscribers. Subscriber growth has been particularly strong in emerging countries. In 2006, we added a new IP–based base station controller to our GSM portfolio, and enhanced our entire line of Evolium GSM/EDGE radio systems to meet the needs of operators for increased capacity and flexibility by optimizing the portfolio to support existing and new data–based applications. The enhancements also increase coverage while reducing power consumption and space requirements, for a lower cost of ownership.

In 2004, we formed an alliance with Intel for the development of end–to–end solutions using WiMAX standards (Worldwide Interoperability for Microwave Access) that provide broadband connectivity over wireless networks, and in 2006 we launched the Evolium WiMAX base station (based on the 802.16e standard) and deployed commercial WiMAX networks and several other WiMAX trials in emerging markets. WiMAX can be a lower–cost alternative in emerging countries that generally do not have an extensive landline network already in place. In 2006 we also inaugurated a WiMAX reality center in Seoul, South Korea to showcase the technology. The WiMAX market is in very early stages of commercial development.

W–CDMA. Wideband Code Division Multiple Access, commonly referred to as W–CDMA and also referred to as Universal Mobile Telephone Communications Systems, or UMTS, is the third generation (or 3G) wireless technology derived from the GSM standard deployed worldwide. Our 2G wireless customers worldwide continue to add voice subscribers and minutes of use to their networks, so voice capacity continues to be a very important driver in their network investment. At the same time, their voice revenues are under pressure from increased competition, and this is driving investment in 3G network solutions that bring new mobile high–speed data capabilities to our customers' networks. Thus, one of the areas in which our customers are focusing relates to 3G mobile high–speed data network deployments. Such deployments consist of upgrading existing base stations and — in some cases — providing new base stations and other equipment that enable operators to introduce mobile high–speed data services at rates comparable to wireline connections.

W–CDMA represents an important evolutionary step over GSM/GPRS/EDGE networks in terms of voice quality, data transmission speeds and the new services they enable. Our customers that utilize Evolium GSM base stations and that wish to migrate to 3G systems can do so relatively easily and inexpensively by incorporating our 3G modules into their systems. Similarly, customers wishing to upgrade their third generation W–CDMA systems with the more advanced HSDPA (High Speed Downlink Packet Access) and HSUPA (High Speed Uplink Packet Access) technology will be able to do so through relatively simple software upgrades to their existing W–CDMA systems. Lucent had its own portfolio of W–CDMA technology and customers – including one of North America's largest operators – and had deployed the world's first commercial HSDPA network (in North America) as well as Europe's first commercial HSDPA network. On December 31, 2006 we increased our W–CDMA portfolio and market position with the acquisition of Nortel's UMTS radio access technology and product portfolio, associated patents and tangible assets as well as customer contracts. In 2006, we acquired Fujitsu's share in the Evolium 3G wireless infrastructure joint venture with them.

CDMA/EV–DO. Lucent's mobility access solutions division forms the basis of our CDMA (Code Division Multiple Access) business. CDMA2000 is a globally deployed 3G wireless technology, predominantly used in North America, Asia Pacific and portions of South America. In 2006, Lucent began deploying the latest variant of CDMA2000, known as 1XEV–DO (Evolution Data Only) Revision A ("Rev A"). With Rev A for CDMA networks and HSDPA/HSUPA for W–CDMA networks, mobile operators are upgrading their networks to support faster high–speed data capabilities and laying the foundation for future enhancements that will enable two–way, real–time data applications such as VoIP, mobile video and walkie–talkie like push–to–talk features. These technologies make the introduction of VoIP services on mobile networks more efficient and increase the data speeds and capacity of 3G networks.

We also have an alliance with Datang Mobile to foster the development of the TD–SCDMA (Time Division–Synchronized Code Division Multiple Access) 3G mobile standard in China, where we worked with Datang in 2006 to deploy trial TD–SCDMA networks. In addition, we have a number of partnerships for the development of equipment and services based on Advanced Telecom Computing Architecture (or ATCA), a standard that reduces the cost and complexity of our customers' mobile infrastructure.

Wireless Transmission. We offer a comprehensive point–to–point portfolio of microwave radio products meeting both European telecommunications standards (or ETSI) and American standard–based (or ANSI) requirements. These products include high, low and medium capacity microwave systems for carriers' transmission systems, mobile backhauling applications, fixed broadband applications and private applications in vertical segments like digital television broadcasting, defense and security, energy and utilities. As a complement to optical fiber and other wireline systems, our portfolio of wireless transmission equipment supports a full range of network/radio configurations, network interfaces and frequency bands with high spectrum efficiency. We introduced a new generation digital microwave radio product in 2006, which provides an effective solution for high–capacity applications, addressing transmission needs for public and private telecommunications networks. We market wireless transmission equipment that can be managed by our complementary software platforms in a fixed or mobile environment.

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Convergence

General. Our convergence business group offers a portfolio of applications, core network hardware and software designed to support the transformation of carriers and service providers to IP–based networks. Our convergence portfolio supports voice, multimedia, entertainment and converged services. Converged services are a combination or "blending" of what were previously standalone services, like a combination of voice, video and Internet data on a conference call. They are designed to be accessible over any kind of access network (wireline, wireless, etc.) and on any kind of communications device. As such, they require an entirely new set of network elements and capabilities. Our convergence group includes products from both historical Alcatel and Lucent, organized around three business divisions: Multimedia and Payment, IMS (IP Multimedia Subsystem) Applications and Services, and Multicore. In 2006, our convergence business group revenues were €1,477 million, (excluding inter–company sales), representing 16.4% of carrier segment revenues and 12.0% of our total revenues.

Multicore. The multicore division offers core networking products that extend from classic switching systems, where we have a leading market position supporting approximately one quarter of the world's installed lines, to IP next–generation core solutions for fixed, mobile and combined operators. We have deployed our IP/NGN solution in more than 245 fixed and mobile networks, and we are involved in more than 20 IMS network transformation projects.

Multimedia & Payment. This division offers multimedia and communications related services such as web information, video and music, as well as payment and messaging products organized around the following portfolios:

- IPTV (Internet Protocol Television – the delivery of broadcast–like television over an IP network), and MultiPlay (multi–player services): interactive, multimedia applications that can be delivered over fixed and mobile networks for residential use and personal entertainment;
- payment: real time rating, charging and billing capabilities for all networks and service providers; for voice, data and video (multi–play) services;
- messaging: voice and multimedia messaging services for mobile, fixed and converged service providers.

We are a world leader in TV, video and music services over telecom networks, with more than 115 fixed and mobile operator customers around the world, including more than 40 triple–play projects, and are a leader in real–time billing and payment with more than 220 fixed and mobile customers.

IMS Application & Services. This division develops applications and converged services for networks that are based on the IP–based IMS architecture, as well as subscriber data management products. IMS services are available over any kind of access network, on any device, and may be blended with other IMS or non–IMS traditional services. Subscriber data management includes software tools that manage a user's subscription, authentication, and location information over a wide range of fixed and mobile network types. Our complete IMS package (application and core network) is in more than 20 deployments or advanced trials, and our subscriber data management applications have been deployed in more than 160 networks.

Enterprise

Our enterprise business segment develops secure, end–to–end business critical communications offerings that enable new business generation, which we market to government agencies and enterprise users. Our enterprise product portfolio includes voice and data applications, such as IP and hybrid–IP telephone systems, call center software and applications, and IP networking products. Our enterprise segment consists largely of historical Alcatel's enterprise activity, which was previously a part of the private communications segment. In 2006, our enterprise business segment revenues were €1,420 million (excluding inter–company sales), representing 11.6% of our total revenues.

Our enterprise communications products are based on open industry standards and protocols to support our customers' current systems and future communications needs. We offer our customers equipment that can be easily upgraded, and we (through our business partners) provide on–premise installation., support and related services. Our Genesys call center products help businesses manage customer interactions and communications, as well as customer service operations and staffing, enabling businesses to intelligently route all incoming customer interactions in real time, including phone, email and Web contacts. We were recognized by several analyst firms, including Gartner and Forrester Research, as a leading supplier of enterprise voice and data products in 2006.

We continue to work with our partners resulting from some significant partnerships we formed in 2004 to support our enterprise business. For the U.S. market, we work under a distribution agreement with a major U.S.–based carrier that permits it to sell our entire historical Alcatel portfolio of enterprise voice and data products. Our contact center software subsidiary has a strategic agreement with Microsoft to deliver products that link telephony and instant messaging applications to deliver real–time voice and data enterprise communications.

Services

Our services business segment provides network integration and other professional services, network operations services, and maintenance services. Our network integration, planning, design, optimization, and management services are critical to simplifying network convergence and the transformation of our carrier and enterprise customers' networks to an all–IP infrastructure and empowering service providers to bring profitable blended services to end–users, while driving increased revenues. Services is increasingly providing these services in a multi–vendor environment — networks that utilize equipment from numerous other vendors. In 2006, our services business segment revenues were €1,721 million (excluding inter–company sales), representing 14.0% of our total revenues.

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Services leverages its core competencies, drawing on the expertise and the innovation of Bell Labs and the rest of our research and development organization to address this opportunity. Services offerings are provided in combination with our products, as well as services that are offered stand-alone or based on other vendors' products. Services has plans aimed at further penetrating markets adjacent to the core service provider market, such as government, enterprise, and cable markets.

Network integration and other professional services (including network planning, design, and optimization services) help our customers identify network areas where they can capitalize on high-margin opportunities, optimize performance and reduce operating expenses, and plan evolution to protect their network investment and increase profits. Enhanced engineering services help our customers determine the best configuration for maximizing traffic capacity and for achieving other operational efficiencies. These services also provide our customers with "in service" upgrades to help them migrate to new technologies. Enhanced technical services help carriers maintain a high-performing network by identifying and correcting network performance issues, balancing traffic loads and integrating new multi-vendor equipment and software into a live system. Professional services help our customers improve network quality by troubleshooting, reporting and resolving problems and providing on-the-job training to their staff.

Maintenance services help our customers improve the performance of their multi-vendor networks and maintain network reliability and availability to ensure quality of service. Remote technical support services provide remote support capabilities to diagnose, resolve and restore the network. On-site technical support services provide technical specialists to deliver on-site maintenance services as our customers expand into new territories, develop new service offers, or face regional technical labor shortages.

Repair and exchange services manage inventory and operating expenses with repair and replacement of critical network hardware. Preventive maintenance services identify, analyze and recommend products and services that help providers keep networks operating at peak performance.

Network operations services consist of a wide range of outsourced network operations and network transformation services that help our clients reduce their operating expenses while preserving and enhancing network reliability. Managed services help provide a seamless transition to an outsourced environment utilizing state-of-the-art tools and technology plus highly skilled technicians to provide ongoing network management of our customers' networks. These functions can be performed at our 10 network operations centers (or NOCs), at our 6 IP transformation centers, or at the customer's network operations center. We currently provide network operation services to more than 50 customers around the world. Hosted services are another type of managed service, typically limited to a specific application that we will manage for our customer. The software-based application could be ours or come from a third party, it could reside on either our customer's network or at one of our NOCs, and it will typically be priced to our customer on a per-transaction basis. This pay-as-you-go pricing mechanism allows a closer matching of customer revenue and cost, helps minimize capital outlays, and reduces "time to market".

By relying on our global multi-vendor expertise and field-proven processes, our customers can leverage their installed base of assets across multiple technologies and vendors, quickly implement new technologies and applications to expand presence in target markets, and simplify operations through customized support to design, build, and manage communication networks.

Marketing and Competition

Marketing and Distribution

We sell substantially all of our products to the world's largest telecommunications service providers through our direct sales force, except in China where our products are also marketed through indirect channels, approved agents and joint ventures that we have formed with Chinese partners. For sales to Tier 2 and Tier 3 service providers, we use our direct sales force and value-added resellers. Our private branch exchange products are sold by distributors.

Competition

We have one of the broadest product and services offerings in the telecommunications service provider market, both for the carrier and non-carrier markets. Our addressable market segment is very broad and our competitors include large companies, such as Avaya, Cisco Systems, Ericsson, Fujitsu, Huawei, ZTE, Motorola, Nokia, Nortel Networks Corporation and Siemens. Some of our competitors, such as Nortel, compete across many of our product lines while others — including a number of smaller companies — compete in one segment or another.

We believe that technological advancement, quality, reliable on-time delivery, product cost, flexible manufacturing capacities, local field presence and long-standing customer relationships are the main factors that distinguish competitors of each of our segments in their respective markets.

We expect that the level of competition in the global telecommunications networking industry will continue to intensify, for several reasons. First, consolidation occurring among vendors, including our transaction with Lucent, the pending joint venture between Nokia and Siemens concerning portions of Siemens's communications business, Cisco's acquisition of Scientific Atlanta, as well as Ericsson and its acquisitions of Marconi, Redback and Entrisphere will create a smaller but stronger set of competitors. We believe most industry participants will seek to strengthen their relationships with large service providers, as the 30 largest providers currently represent approximately 75% of global carrier spending. In addition, carrier consolidation continues, resulting in fewer customers. Competition is also accelerating around converged network technologies as carriers are shifting capital to areas that will enable network migration. Furthermore, competitors providing low-priced products and services from Asia are gaining market share worldwide. As a result, we continue to operate in an environment of increased competitive pricing.

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Research and Development and Intellectual Property

Research and Development

Our combination with Lucent adds Bell Labs to Research & Innovation, our research arm, creating a community of researchers and scientists in 10 countries: the U.S., Canada, France, Germany, Belgium, the U.K., Ireland, Netherlands, India and China. In 2006, our research and development expenses were €1,466 million, representing 11.9% of our 2006 revenues after the impact of the capitalization of development expenses (€1,574 million, or 12.8% of 2006 revenues, before capitalization of development expenses). For a detailed discussion of our research and development expenditures for the past three years and certain accounting policies relating to our research and development and acquired technologies, see Item 5 — "Operating and Financial Review and Prospects."

Research and development is one of our key priorities because we believe the development of our key technologies for the carrier telecommunications market can provide significant differentiation in the marketplace and lead to significant future revenues for the Group. At the same time, we made major efforts in 2006 to improve the quality, efficiency and promotion of research and development activities. For example, we continued to reduce spending on mature technologies, discontinued non−competitive and non−core programs, slowed research and development spending in non−urgent programs, and reduced capital expenditures relating to investments in platforms, test tools, and certain development efforts. We adopted measures to promote the reuse of existing technology across our business segments and to increase efficiency, especially in the area of software production. We also adopted engineering best practices for the development and maintenance of products and services across their entire life cycle.

Our key research priorities include the technologies we view as central to our business strategy, including:

- multimedia and mobile/fixed services and applications;
- new service delivery architectures and platforms;
- wireless and wireline broadband access;
- packet and optical networking;
- network security;
- network optimization;
- fundamental and applied research in mathematics, physical sciences, nanotechnology, and computer and software sciences.

Intellectual Property

We rely on patent, trademark, trade secret and copyright laws both to protect our proprietary technology and to protect us against claims from others. We believe that we have direct intellectual property rights or rights under licensing arrangements covering substantially all of our material technologies. However, there can be no assurance that claims of infringement will not be asserted against us or against our customers in connection with their use of our systems and products, nor can there be any assurance as to the outcome of any such claims, given the technological complexity of our systems and products.

We consider patent protection to be particularly important to our businesses due to the emphasis on research and development and intense competition in our markets. In 2006, historical Alcatel and Lucent filed a combined 1,396 patent applications (710 filed by historical Alcatel and 686 filed by Lucent) and had a portfolio of 25,000 active patents worldwide across a vast array of technologies. We do not believe that any single patent or group of related patents is material to our business as a whole.

We are actively pursuing a strategy to license selected technologies through our licensing program in order to expand the reach of our technologies and to generate licensing revenues.

Sources and Availability of Materials

We make significant purchases of electronic components and other materials from many domestic and foreign sources. While there have been some shortages in components and some other materials in technology commodities common across the industry, we have generally been able to obtain sufficient materials and components from various sources around the world to meet our needs. We continue to develop and maintain alternative sources of supply for essential materials and components. We do not have a concentration of sources of supply of materials, labor or services that, if suddenly eliminated, could severely impact our operations, and we believe that we will be able to obtain sufficient materials and components from U.S., European and other world market sources to meet our production requirements.

Properties

We have administrative, production, systems integration/manufacturing, warehouse, and research and development facilities worldwide. A substantial portion of our production and research activities in all business areas is conducted in France, the U.S. and China. We also have operating affiliates and production plants in many other countries, including Germany, Italy, Spain, Belgium, Canada, the U.K., Poland, India, Brazil and Mexico. As of December 31, 2006, our total global productive capacity was approximately 575,000 square meters (excluding any properties which are part of the businesses to be transferred to Thales), as described below, of which approximately 60% is owned and the remainder is leased.

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Business Segment *(in thousands of square meters)*	**Europe**	**North America**	**Asia Pacific**	**Total**
Carrier	243	211	102	556
Enterprise	15	0	0	15
Services	4	0	0	4
GROUP TOTAL	**262**	**211**	**102**	**575**

We believe that our current facilities are in good condition and adequate to meet the requirements of our present and foreseeable future operations.

We have been largely outsourcing the manufacturing of many of our telecommunications products in an effort to obtain greater flexibility to adapt quickly to economic and market changes and in order to decrease our costs. Consequently, we currently use contract manufacturers to supply most of our product lines, but we continue to integrate and test internally many of these products. Celestica Corporation manufactures most of Lucent's wireless products, Solectron Corporation manufactures most of Lucent's wireline products, Sanmina-SCI manufactures a substantial volume of historical Alcatel's products, as does our joint venture Alcatel Shanghai Bell. Our contract manufacturers also include other local companies in various regions. They use their leverage and global buying power to negotiate prices from vendors we approve.

Our Activities in Certain Countries

We operate in more than 130 countries, some of which have been accused of human rights violations, are subject to economic sanctions by the U.S. Treasury Department's Office of Foreign Assets Control or have been identified by the U.S. State Department as state sponsors of terrorism. Some U.S.-based pension funds and endowments have announced their intention to divest the securities of companies doing business in some of these countries and some state and local governments have adopted, or are considering adopting, legislation that would require their state and local pension funds to divest their ownership of securities of companies doing business in those countries. Our net revenues attributable to these countries represented less than one percent of our total net revenues. We estimate that prior to the business combination with Lucent, U.S.-based pension funds and endowments owned approximately 1.4% of our outstanding stock, and most of these institutions have not indicated that they intend to effect such divestment.

Environmental Matters

We are subject to national and local environmental and health and safety laws and regulations that affect our operations, facilities and products in each of the jurisdictions in which we operate. These laws and regulations impose limitations on the discharge of pollutants into the air and water, establish standards for the treatment, storage and disposal of solid and hazardous waste and may require us to clean up a site at significant cost. In the U.S., these laws often require parties to fund remedial action regardless of fault. We have incurred significant costs to comply with these laws and regulations and we expect to continue to incur significant compliance costs in the future.

Remedial and investigatory activities are under way at numerous current and former facilities owned or operated by Lucent entities. In addition, Lucent was named a successor to AT&T as a potentially responsible party at numerous Superfund sites pursuant to the Comprehensive Environmental Response, Compensation and Liability Act of 1980 ("CERCLA") or comparable state statutes. Under a Separation and Distribution Agreement with AT&T and NCR Corp. (a former subsidiary of AT&T), Lucent is responsible for all liabilities primarily resulting from or relating to its assets and the operation of its business as conducted at any time prior to or after the separation from AT&T, including related businesses discontinued or disposed of prior to its separation from AT&T. Furthermore, under that Separation and Distribution Agreement, Lucent is required to pay a portion of contingent liabilities in excess of certain amounts paid out by AT&T and NCR, including environmental liabilities. In Lucent's separation agreements with Agere and Avaya, those companies have agreed, subject to certain exceptions, to assume all environmental liabilities related to their respective businesses.

It is our policy to comply with environmental requirements and to provide workplaces for employees that are safe and environmentally sound and that will not adversely affect the health or environment of communities in which we operate. Although we believe that we are in substantial compliance with all environmental and health safety laws and regulations and that we have obtained all material environmental permits required for our operations and all material environmental authorizations required for our products, there is a risk that we may have to incur expenditures significantly in excess of our expectations to cover environmental liabilities, to maintain compliance with current or future environmental and health and safety laws and regulations or to undertake any necessary remediation. The future impact of environmental matters, including potential liabilities, is often difficult to estimate.

Seasonality

Alcatel's historical quarterly results reflect seasonality in the sale of its services and products. Sales were generally stable over the first three quarters of the year, with the strongest sales in the fourth quarter. However, the merger with Lucent should mitigate this historical seasonality, as Lucent's revenues and earnings have not demonstrated consistent seasonal characteristics.

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Item 4A. Unresolved Staff Comments

Not applicable.

Item 5. Operating and Financial Review and Prospects

Forward-Looking Information

This Form 20-F, including the discussion of our Operating and Financial Review and Prospects, contains forward-looking statements based on beliefs of our management. We use the words "anticipate," "believe," "expect," "may," "intend," "should," "plan," "project," or similar expressions to identify forward-looking statements. Such statements reflect our current views with respect to future events and are subject to risks and uncertainties. Many factors could cause the actual results to be materially different, including, among others, changes in general economic and business conditions, changes in currency exchange rates and interest rates, introduction of competing products, lack of acceptance of new products or services and changes in business strategy. Such forward-looking statements include, but are not limited to, the forecasts and targets set forth in this Form 20-F, such as the discussion in Item 4 – "Information on the Company – History and Development – Overview" and below in this Item 5 under the heading "Overall Perspective" with respect to (i) our expectation that in the first quarter of 2007 we will have some decline in revenue from the year-ago quarter, (ii) our view that our revenues should increase on a percentage basis in an amount at least equal to the carrier market growth rate of mid-single digits for the full year 2007, (iii) our expectation that we will recognize at least €600 million in merger-related synergies and other cost reductions in 2007, (iv) the amount of expected cash receipts, capital expenditures and other cash outlays in 2007 and (v) the amount we would be required to pay in the future pursuant to our existing contractual obligations and off-balance sheet contingent commitments, included below in this Item 5 in this discussion under the heading "Contractual obligations and off-balance sheet contingent commitments." Our revenue expectations, as discussed above for the first quarter and for the full year 2007, apply to the combined results of historical Alcatel and Lucent as if the combination had occurred as of January 1, 2006.

Presentation of Financial Information

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes presented elsewhere in this document. Our consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union, which differ in certain significant ways from accounting principles generally accepted in the United States ("U.S. GAAP"). IFRS, as adopted by the European Union, differs in certain respects from the International Financial Reporting Standards issued by the International Accounting Standards Board. However, our consolidated financial statements for the year presented in this document in accordance with IFRS would be no different if we had applied International Financial Reporting Standards issued by the International Accounting Standards Board. References to "IFRS" in this Form 20-F refer to IFRS as adopted by the European Union. The most significant differences between IFRS and U.S. GAAP that are applicable to our financial results relate to the accounting treatment of business combinations before the date of transition to IFRS (January 1, 2004), capitalization of development costs, accounting of post-employment benefits, accounting for share-based payment transactions, accounting of compound financial instruments, accounting for sale and leaseback transactions and accounting for restructuring costs. For a discussion of the significant differences between IFRS and U.S. GAAP as they relate to our consolidated financial statements, and a reconciliation of our net income (loss) for the year ended December 31, 2006 and shareholders' equity as of that date to U.S. GAAP, please refer to Notes 38 through 41 to our consolidated financial statements included elsewhere in this annual report.

Further, the following discussion takes into account our results of operations under IFRS for the year ended December 31, 2006, (i) including Lucent's results of operations starting on December 1, 2006 and (ii) excluding the businesses to be transferred to Thales. As a result of purchase accounting treatment of the Lucent business combination required by IFRS, our results for 2006 included several negative, non-cash adjustments. In addition, the following discussion takes into account our results of operations for the years ended December 31, 2005 and 2004 which have been re-presented as required by IFRS, to exclude the businesses to be transferred to Thales, which are shown as discontinued operations.

Changes in Accounting Standards as of January 1, 2006

As a result of the publication of the "Fair Value Option" amendment to IAS 39 "Financial Instruments: Recognition and Measurement", effective January 1, 2006, certain marketable securities previously included in the category of financial assets at fair value through profit or loss are now designated as financial assets available for sale. The impact of this change, had it been applied in 2005, is presented in Note 8 – Financial income (loss) and in the consolidated statement of changes in shareholders' equity in our consolidated financial statements included elsewhere in this annual report.

Critical Accounting Policies

Our Operating and Financial Review and Prospects is based on our consolidated financial statements, which are prepared in accordance with IFRS as described in Note 1 to those consolidated financial statements. As noted above, the principal differences between IFRS and U.S. GAAP are detailed in the Notes to our consolidated financial statements. Some of the accounting methods and policies used in preparing our consolidated financial statements under IFRS and the reconciliation of our net income and shareholders' equity to U.S. GAAP are based on complex and subjective assessments by our management or on estimates based on past experience and assumptions deemed realistic and reasonable based on the circumstances concerned. The actual value of our assets, liabilities and shareholders' equity and of our earnings could differ from the value derived from these estimates if conditions changed and these changes had an impact on the assumptions adopted.

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We believe that the accounting methods and policies listed below are the most likely to be affected by these estimates and assessments:

Valuation allowance for inventories and work in progress

Inventories and work in progress are measured at the lower of cost or net realizable value. Valuation allowances for inventories and work in progress are calculated based on an analysis of foreseeable changes in demand, technology or the market, in order to determine obsolete or excess inventories and work in progress.

The valuation allowances are accounted for in cost of sales or in restructuring costs depending on the nature of the amounts concerned.

The impact of inventory and work in progress write-downs on our income before tax was a net charge of €77 million in 2006 (net charge of €18 million in 2005 and a net gain of €20 million in 2004), representing new write-downs taken in 2006 which more than offset the reversal of existing provisions of €98 million due to asset sales that occurred in 2006.

Impairment of customer receivables and loans

An impairment loss is recorded for customer receivables if the present value of the future receipts is below the nominal value. The amount of the impairment loss reflects both the customers' ability to honor their debts and the age of the debts in question. A higher default rate than estimated or the deterioration of our major customers' creditworthiness could have an adverse impact on our future results. Impairment losses on customer receivables were €192 million at December 31, 2006 (€228 million at December 31, 2005 and €284 million at December 31, 2004). The impact of impairment losses for customer receivables on income (loss) before tax, related reduction of goodwill and discontinued operations was a net charge of €18 million in 2006 (a net gain of €19 million in 2005 and a net gain of €43 million in 2004).

Impairment losses on customer loans and other financial assets (assets essentially relating to customer financing arrangements) were €838 million at December 31, 2006 (€897 million at December 31, 2005 and €908 million at December 31, 2004). The impact of these impairment losses on income before tax, related reduction of goodwill and discontinued operations was a net gain of €2 million in 2006 (a net gain of €25 million in 2005 and a net gain of €77 million in 2004).

Goodwill, capitalized development costs and other intangible assets

Capitalized development costs

The criteria for capitalizing development costs are set out in Note 1f. Once capitalized, these costs are amortized over the estimated lives of the products concerned. We must therefore evaluate the commercial and technical feasibility of these development projects and estimate the useful lives of the products resulting from the projects. Should a product fail to substantiate these assumptions, we may be required to impair or write off some of the capitalized development costs in the future.

An impairment loss of €104 million and write-offs amounting to €197 million have been accounted for in capitalized development costs in 2006, and are mainly related to the discontinuance of product lines following the acquisition of UMTS technologies from Nortel and the business combination with Lucent (refer to Notes 3, 7 and 13 to our consolidated financial statements included elsewhere in this annual report).

Goodwill and Intangible assets

Goodwill amounting to €8,051 million and intangible assets amounting to €4,813 million were accounted for in 2006 in connection with the Lucent business combination as described in Note 3 to our consolidated financial statements included elsewhere in this annual report. Using market-related information, estimates (primarily based on risk-adjusted discounted cash flows) and judgment, an independent appraiser determined the preliminary fair values of the net assets acquired from Lucent, and in particular those relating to the intangible assets acquired. If the expected results of the acquired business in the future do not support such fair values and the goodwill resulting from the business combination, impairment charges against such intangible assets and goodwill may be required in future financial statements. Goodwill and intangible assets related to the Lucent transaction are preliminary and subject to change.

An impairment loss of €40 million and write-offs amounting to €233 million have been accounted against intangible assets in 2006, mainly related to discontinued product lines following the acquisition of UMTS technologies from Nortel and the business combination with Lucent (refer to Notes 3, 7 and 13 to our consolidated financial statements included elsewhere in this annual report).

As indicated in Note 1g to our consolidated financial statements included elsewhere herein, in addition to the annual goodwill impairment tests, timely impairment tests are carried out in the event of indications of reduction in value of intangible assets held. Possible impairments are based on discounted future cash flows and/or fair values of the assets concerned. A change in the market conditions or the cash flows initially estimated can therefore lead to a review and a change in the impairment loss previously recorded.

Net goodwill was €10,977 million at December 31, 2006 (€3,772 million at December 31, 2005 and €3,774 million at December 31, 2004). Other intangible assets, net were €5,347 million at December 31, 2006 (€819 million at December 31, 2005 and €705 million at December 31, 2004).

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Impairment of property, plant and equipment

In accordance with IAS 36 "Impairment of Assets," when events or changes in market conditions indicate that tangible or intangible assets may be impaired, such assets are reviewed in detail to determine whether their carrying value is lower than their recoverable value, which could lead to recording an impairment loss (recoverable value is the higher of its value in use or its fair value less costs to sell) (see Note 1g to our consolidated financial statements included elsewhere herein). Value in use is estimated by calculating the present value of the future cash flows expected to be derived from the asset. Fair value less costs to sell is based on the most reliable information available (market statistics, recent transactions, etc.).

The planned closing of certain facilities, additional reductions in personnel and reductions in market outlooks have been considered impairment triggering events in prior years. No significant impairment losses were recorded in 2006, 2005 or 2004.

When determining recoverable value of property, plant and equipment, assumptions and estimates are made, based primarily on market outlooks, obsolescence and sale or liquidation disposal values. Any change in these assumptions can have a significant effect on the recoverable amount and could lead to a revision of recorded impairment losses.

Provision for warranty costs and other product sales reserves

Provisions are recorded for (i) warranties given to customers on our products, (ii) expected losses and (iii) penalties incurred in the event of failure to meet contractual obligations on construction contracts. These provisions are calculated based on historical return rates and warranty costs expensed as well as on estimates. These provisions and subsequent changes to the provisions are recorded in cost of sales either when revenue is recognized (provision for customer warranties) or, for construction contracts, when revenue and expenses are recognized by reference to the stage of completion of the contract activity. Costs and penalties that eventually will be paid can differ considerably from the amounts initially reserved and could therefore have a significant impact on future results.

Product sales reserves represented €670 million at December 31, 2006, of which €71 million related to construction contracts (see Note 18 to our consolidated financial statements included elsewhere in this annual report) (€753 million at December 31, 2005, of which €173 million related to construction contracts and €933 million and €271 million, respectively, at December 31, 2004). For further information on the impact on 2006 income (loss) from operating activities before restructuring costs, impairment of intangible assets and gain /(loss) on disposal of consolidated entities of the change in these provisions, see "Consolidated Results of Operations for the Year Ended December 31, 2006 Compared to the Year Ended December 31, 2005" and Notes 18 and 27 our consolidated financial statements included elsewhere herein.

Deferred taxes

Deferred tax assets relate primarily to tax loss carryforwards and to deductible temporary differences between reported amounts and the tax bases of assets and liabilities. The assets relating to the tax loss carryforwards are recognized if it is probable that the Group will generate future taxable profits against which these tax losses can be set off.

At December 31, 2006, deferred tax assets were €1,692 million, of which €746 million related to the United States and €372 million to France (€1,606 million at December 31, 2005, of which €850 million related to the United States and €369 million to France). Evaluation of our capacity to utilize tax loss carryforwards relies on significant judgment. We analyze the positive and negative elements of certain economic factors that may affect our business in the foreseeable future and past events to conclude as to the probability of utilization in the future of these tax loss carryforwards, which also consider the factors indicated in Note 1n to our consolidated financial statements included elsewhere herein. This analysis is carried out regularly in each tax jurisdiction where significant deferred tax assets are recorded.

If future taxable results are considerably different from those forecast that support recording deferred tax assets, we will be obliged to revise downwards or upwards the amount of the deferred tax assets, which would have a significant impact on our balance sheet and net income (loss).

As a result of the business combination with Lucent, €2,405 million of net deferred tax liabilities have been recorded resulting from the temporary differences generated by the differences between the fair valuation of assets and liabilities acquired (mainly intangible assets such as acquired technologies) and their corresponding tax bases. These deferred tax liabilities will be reversed in the Group's future statements of income as and when such differences are amortized.

As prescribed by IFRS, we have a twelve–month period to complete the Lucent purchase price allocation and to determine whether certain deferred tax assets related to the carryforward of Lucent's unused tax losses that have not been recognized in Lucent's historical financial statements should be recognized in our financial statements. If any deferred tax assets related to the business combination (resulting from Lucent's unrecognized tax losses) are recorded in our future financial statements, the impact will be accounted for (as income) in the statement of income. However, in addition, goodwill will be reduced (resulting in an expense) for that part of the losses recognized relating to Lucent's tax losses.

On the other hand, subsidiaries of historical Alcatel may consider that, as a result of the business combination with Lucent, it is probable that they will recover their own tax losses not recognized as a deferred tax asset before the business combination. For example, an entity may be able to utilize the benefit of its own unused tax losses against the future taxable profit of the Lucent business. In such cases, we would recognize a deferred tax asset but would not include it as part of the accounting for the business combination. It could therefore have a positive impact on our future net results.

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Pension and retirement obligations and other employee and post-employment benefit obligations

Due to the business combination with Lucent, our results of operations include the impact of significant pension and post-retirement benefits that are measured using actuarial valuations. Inherent in these valuations are key assumptions, including assumptions about discount rates, expected return on plan assets and expected participation rates in retirement health care plans. These assumptions are updated on an annual basis at the beginning of each fiscal year or more frequently upon the occurrence of significant events. Changes in the related pension and post-retirement benefit costs or credits may occur in the future due to changes in the assumptions. The net effect of pension and post-retirement cost included in our income (loss) before tax, related reduction of goodwill and discontinued operations was €120 million, €93 million and €104 million during fiscal 2006, 2005 and 2004, respectively.

The weighted average expected rate of return on pension plan assets used to develop our pension credit was 7.35% (computed on a yearly basis including businesses acquired during the year), 4.28% and 4.70% during fiscal 2006, 2005 and 2004, respectively, and is determined at the beginning of the period. We plan to use an expected rate of return of 7.25% during fiscal 2007. Changes in the rate were generally due to different expected future returns based on studies performed by our external investment advisors or to a change of the asset allocation. Similar changes were made to our expected rate of return on post-retirement plan assets due to lower expected future returns, as well as for changes in the mix of assets held. A lower expected rate of return reduces our net pension result and profitability.

The weighted average discount rate used to determine the pension credit was 3.98% for Alcatel and its subsidiaries and 5.44% for Lucent and its subsidiaries, each prior to the business combination in 2006 and 4.46% and 4.81% during fiscal 2005 and 2004, respectively. The discount rate is determined at the beginning of the period. We plan to use a weighted average discount rate of 5.54% during fiscal 2007. Changes in the discount rate were due to increasing long-term interest rates during 2006. The discount rate is also somewhat volatile because it is determined based upon the prevailing rate as of the measurement date. Similar adjustments were made to the discount rate used to determine our post-retirement benefit costs. The discount rate used to determine the post-retirement benefit costs is slightly lower due to a shorter expected duration of post-retirement plan obligations as compared to pension plan obligations. A lower discount rate increases the plan obligations and reduces our net pension credit and profitability for those plans where actuarial losses are being amortized. Otherwise, a higher discount rate increases our net pension credit and profitability.

The expected rate of return on pension plan assets and the discount rate as well as the amortization of unrecognized actuarial gains and losses were determined in accordance with consistent methodologies, as described in Note 1k to our consolidated financial statements included elsewhere in this document.

Holding all other assumptions constant, a 0.5% increase or decrease in the discount rate would have increased/decreased the fiscal 2006 net pension result by approximately €28 million and €20 million, respectively. The impact of changes in the discount rate is different if the resulting actuarial gains or losses are subject to amortization. A 0.5% increase or decrease in the expected return on plan assets would have increased or decreased the fiscal 2006 net pension result by approximately €35 million.

In the U.S., there have been several recent developments related to retiree health care benefits, including changes in benefits, cost sharing and legislation, such as Medicare Part D of the Medicare Prescription Drug Improvement and Modernization Act of 2003.

Lucent has taken various actions to reduce its share of retiree health care costs during recent periods, including the shifting of certain costs to its retirees. Lucent's retiree health care obligations are determined using the terms of the current plans, under which health care benefits for employees who retired prior to March 1, 1990 are not subject to annual dollar caps on Lucent's share of future benefit costs. The benefit obligation associated with this retiree group approximates 60% of Lucent's total retiree health care obligation. Management employees who retired on or after March 1, 1990 have paid premiums above the applicable annual dollar caps on Lucent's share of future benefit costs since 2001. Lucent's collective bargaining agreements were ratified during December 2004 and address retiree health care benefits, among other items. Lucent agreed to continue to subsidize these benefits up to the established cap level consistent with Lucent's current actuarial assumptions. Except for costs attributable to an implementation period that ended on February 1, 2005, costs that are in excess of this capped level are being borne by the retirees in the form of premiums and plan design changes. Lucent also agreed to establish a new U.S. $400 million trust to be funded over eight years and managed jointly by trustees appointed by Lucent and the unions, U.S. $50 million of which has been contributed and U.S. $25 million of which has been provided for through a Section 420 transfer. The remaining U.S. $325 million of contributions to the trust, which may be funded in Lucent's discretion either from operating cash or excess pension assets, would be required if the conditions described in the risk factor in Item 3 above (concerning Lucent's pension and post-retirement benefit plans) are met. The trust is being used to mitigate the cost impact on retirees of premiums or plan design changes. The agreements also acknowledge that retiree health care benefits will no longer be a subject of bargaining between Lucent and the unions.

Under IFRS, the amount of prepaid pension costs that can be recognized in our financial statements is limited to the sum of the cumulative unrecognized net actuarial losses and past service cost, the present value of any available refunds from the plan, and any reduction in future contributions to the plan. As Lucent currently has the ability and intent to use eligible excess pension assets to fund certain retiree health care benefits for formerly represented retirees, such use has been considered as a refund from the related plans. The funded status of the formerly represented retiree health care obligation of approximately €(1.9) billion, the present value of Medicare Part D subsidies of approximately €360 million (as this amount is currently netted in the retiree health care obligation) and the present value of future service costs of €182 million have been considered in determining the asset ceiling limitation for Lucent's pension plans as of December 31, 2006.

The expected future economic benefits related to pension plan assets in determining the asset ceiling is a complex matter. As of the January 1, 2007 valuation date, there were approximately €1.6 billion of pension plan assets that would be eligible for "collectively bargained" transfers to fund retiree health care costs for Lucent's formerly represented retirees (alternatively, €1.2 billion would be available for conventional transfers). Lucent has assumed that the eligible plan assets will increase over time through the 2013 expiration date of the current legislation and as a result Lucent will be able to utilize more pension plan assets for Section 420 transfers than are available as of December 31, 2006. Changes in plan asset values, funding levels or legislation could result in significant changes in the asset ceiling. This could result in significant volatility in our results of operations or a reduction in the pension credit that could be recognized in our results of operations. The pension credit related to Lucent's occupational pension plans was reduced by €61 million during the month ended December 31, 2006, due to this asset ceiling.

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Revenue recognition

As indicated in Note 1o to our consolidated financial statements included elsewhere herein, revenue is measured at the fair value of the consideration received or to be received when the Group has transferred the significant risks and rewards of ownership of a product to the buyer.

For revenues and expenses generated from construction contracts, we apply the percentage of completion method of accounting, provided certain specified conditions are met, based either on the achievement of contractually defined milestones or on costs incurred compared with total estimated costs. The determination of the stage of completion and the revenues to be recognized rely on numerous estimations based on costs incurred and acquired experience. Adjustments of initial estimates can, however, occur throughout the life of the contract, which can have significant impacts on our net income (loss).

For arrangements to sell software licenses with services, software license revenue is recognized separately from the related service revenue, provided the transaction adheres to certain criteria (as prescribed by the Statement of Position (SOP) 97–2) of the American Institute of Certified Public Accountants, or the AICPA, such as the existence of sufficient vendor–specific objective evidence ("VSOE") to determine the fair value of the various elements of the arrangement.

Some of the Group's products include software that is embedded in the hardware at delivery. In those cases where indications are that software is more than incidental, such as where the transaction includes software upgrades or enhancements, software revenue recognition rules are applied to determine the amount and timing of revenue recognition. As products with embedded software are continually evolving, and the features and functionality of the products driven by software components are becoming more critical to their operation and success in the market, the Group is continually assessing the applicability of SOP 97–2 including whether software is more than incidental. Several factors are considered in making this determination including (1) whether the software is a significant focus of the marketing effort or is sold separately, (2) whether updates, upgrades and other support services are provided on the software component and (3) whether the costs to develop the software component of the product is significant in relation to the costs to develop the product as a whole. The determination of whether the evolution of our products and marketing efforts should result in the application of SOP 97–2 requires the use of significant professional judgement. Further, we believe that reasonable people evaluating similar facts and circumstances may come to different conclusions regarding the most appropriate accounting model to apply in this environment particularly if VSOE can be obtained. Our future results of operations may be significantly impacted, particularly due to the timing of revenue recognition, if we change our assessment as to whether software is incidental.

For product sales made through distributors, product returns that are estimated according to contractual obligations and past sales statistics are recognized as a reduction of sales. If the actual product returns were considerably different from those estimated, the resulting impact on our income statement could be significant.

It can be difficult to evaluate our capacity to recover receivables. Such evaluation is based on the customers' creditworthiness and on our capacity to sell such receivables without recourse. If, subsequent to revenue recognition, the recoverability of a receivable that had been initially considered as likely becomes doubtful, a provision for an impairment loss is then recorded.

Derecognition of financial assets

A financial asset, as defined under IAS 32 "Financial Instruments: Disclosure and Presentation," is either totally or partially derecognized (removed from the balance sheet) when (i) we expect that no further cash flow will be generated by it, (ii) we transfer substantially all risks and rewards attached to the asset or (iii) we retain no control of the asset.

With respect to trade receivables, a transfer is considered without recourse when the risk of payment default by the debtor has been transferred and the risk of late payment is considered marginal. Potential new interpretations in the future of the concept of "substantial transfer of risks and rewards" could lead us to modify our current accounting treatment.

Operating and financial review and prospects

Overall Perspective

Overview of 2006. The overall telecommunications equipment market continued to grow at a mid–single digit rate in 2006. During 2006, carriers continued to transform their networks toward a high bandwidth, full IP architecture providing enhanced triple play services to end–users, which positively impacted our wireline segment. Broadband access remained a key focus area for wireline carriers, with an increasing emphasis on deploying optical fiber deeper into access networks. The growing prevalence of broadband connections has facilitated growth in bandwidth–intensive traffic like video, which has, in turn, lead to renewed spending for added capacity in metro and long–haul optical networks. Wireless operators continued to invest in higher speed data capabilities of third generation networks, but the wireless infrastructure market was also adversely impacted by increased competition and pricing pressure, particularly in GSM, as the number of greenfield deployments has diminished.